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## BRITISH INCOME TAX REFORM

The British income tax is again under scrutiny. The Royal Commission on the Income Tax—the first commission since 1861 to make a complete inquiry into the subject—issued its report in March,<sup>1</sup> after a year's "intricate and difficult inquiry . . . into the efficient working of the greatest financial engine that has ever been devised in any country."<sup>2</sup> The publications of the commission, comprising, in addition to the final report, seven volumes of evidence with appendices containing detailed historical, statistical, and graphic information, bear testimony to the painstaking work of the commission on the problems of income tax reform.

The recommendations embodied in the report are moderate. Although numerous and detailed changes in the act are proposed, the essential nature of the tax remains untouched. The general structure of income and supertax rates, with the features of graduation and differentiation, is approved. The principal reforms advocated have to do with the raising of the exemption limit, increases in allowances, simplification of the graduation and differentiation schemes, and a number of administrative changes. Expressions of relief from an already heavily taxed public found their way into print as soon as the moderate nature of the recommendations was appreciated.<sup>3</sup> The attitude of the government is expressed in the statement of the Chancellor of the Exchequer that the recommendations would be considered by the government "with every desire to accept them."<sup>4</sup> The fact that the report was signed by all the members of the commission, after a full inquiry, would carry such weight that the strongest reasons would be necessary to warrant any material departure from their recommendations, according to the Chancellor.

*The history and present status of the income tax.* Proceeding with a thoroughness which later became proverbial, the commission opened its deliberations by hearing the evidence of one of the commissioners of inland revenue, Mr. R. V. N. Hopkins. The full and detailed summaries and statistical tables presented by Mr. Hopkins, incorporated in the Minutes of Evidence, afford the most

<sup>1</sup> *Report of the Royal Commission on the Income Tax* (Cmd. 615), 1920.

<sup>2</sup> Speech of the Chancellor of the Exchequer (Mr. Chamberlain) at the commission's dinner, Mar. 11, 1920.

<sup>3</sup> *Manchester Guardian* (weekly edition), Apr. 2, 1920, p. 282.

<sup>4</sup> *Daily Telegraph* (London), Mar. 13, 1920.

complete analysis of the history and operation of the act which has yet been presented to the public.<sup>5</sup>

Taxes graded according to income were first imposed in Great Britain in 1798, at the instance of William Pitt, in order to meet the financial burden of the war with France. The results in the first year were financially disappointing, but the act paved the way for a tax of 10 per cent upon incomes, imposed in the following year. In 1802, following the declaration of peace, the income tax law was repealed, but in 1803 the resumption of war caused its revival. In that year the rate was fixed at 5 per cent and the five schedules, A, B, C, D, and E, which make up the income tax of today, were used. The tax of this period remained in force until 1816, when it was abandoned.

In 1842 Sir Robert Peel restored the income tax in a form which has survived repeated modifications and remains the basis of the income tax of today. The rate of the tax was 7d. in the pound (3 per cent) and the exemption limit was £150. In 1853 Mr. Gladstone, in his famous budget speech, emphasized the usefulness of the income tax as a source of war revenue, but opposed its retention as a permanent measure in times of peace. Accordingly, in the same year in which Ireland was included in the income tax scheme, Mr. Gladstone devised a plan by which the tax would gradually decline during a seven-year period and expire in 1860. The outbreak of the Crimean War disturbed this program and gave the tax a new lease of life. In 1855 and 1856 the rate was 1s. 4d. in the £ (6½ per cent), the highest point reached from the re-introduction of the tax in 1842 to the outbreak of the war in 1914.

With the return of peace and the readjustment of the country's financial affairs, the rates fell to low levels, notably in 1874 and 1875, when the tax was 2d. in the £ (less than 1 per cent). The tax survived various proposals for repeal, and underwent no important changes in structure until 1907, when the differentiation of earned and unearned incomes was effected. In 1910 the introduction of graduation by means of a supertax on the larger incomes marked a second important structural change.

During the Great War the income tax has been amplified and readjusted repeatedly in order to produce an ever-increasing amount of revenue. At the time of the outbreak of the war the

<sup>5</sup> *First Instalment of the Minutes of Evidence*, pp. 1-14; appendices nos. 1, 2, 3.

general rate of the tax was 1s. 3d., a rate which was modified by abatements and allowances on the one hand and the addition of supertaxes on the other. The war budget of November, 1914, increased the income and supertaxes by one third. For 1915-1916 the taxes were doubled. Further increases were brought about by the lowering of the exemption limit from £160 to £130 and by repeatedly raising the rates. By the end of the war the standard rate had reached 6s. (30 per cent) and the supertax rate 4s. 6d. (22.5 per cent), making an effective rate on the largest incomes of 52.5 per cent. The consolidation of the income tax acts in 1918 brought together the various enactments into one compendious statute, which stands as the income tax law of today.

At the present time the income tax of the United Kingdom extends to the income of individuals and the undistributed profits of corporations. It applies to (a) all income arising in the United Kingdom, by whomsoever enjoyed, and (b) the income of all persons residing in the United Kingdom, without regard to the place of origin.

Income is divided into five kinds, classified in schedules as follows:

- Schedule A. Profits from the ownership of lands and buildings.
- Schedule B. Profits from the occupation of land.
- Schedule C. Profits from investments in the public funds.
- Schedule D. Profits from trades, professions and employments.
- Schedule E. Profits from emoluments of public offices.

Corporations and non-residents are taxed at the standard rate of 6s. in the £ (30 per cent). For individuals resident in the United Kingdom the standard rate is 6s. in the £, but graduation and differentiation are also employed.

Graduation is effected in two ways: *downwards*, by reduction of the standard rate for incomes of £2,500 and less; and *upwards*, by the application of an (additional) graduated tax—the super-tax—to incomes of more than £2,500. Individuals whose incomes do not exceed £130 are entirely exempt. Incomes exceeding £130 but not exceeding £2,500 are subject to tax by rates ranging from 2s. to 5s. 3d. in the case of earned incomes, and from 3s. to 6s. in the case of unearned incomes. Further relief in the form of abatements and allowances for wife, children, and certain relatives is given in the case of the smaller incomes. The super-tax is chargeable if the income exceeds £2,500, and at £10,000 reaches a maximum of 4s. 6d. Differentiation is not employed

for incomes above £2,500. In so far as possible the tax is collected at the source.

In recent years the income tax has outstripped in importance all other forms of taxation, including even the high excess profits tax imposed in the war period, and has earned anew its old title of the "sheet-anchor" of national finance. In the financial year 1918-1919 the exchequer receipts from the income tax and super-tax were £291,000,000, or one third (32.8 per cent) of the total receipts.

No fiscal measure can attain so important a position without becoming the object of constant and detailed scrutiny. At such a height a slight defect in the tax is ground for a serious grievance. Every inequality and irregularity is a source of irritation. Furthermore, the possibility that this tax, commonly regarded as having a high degree of elasticity, has reached the limit of its expansion, cannot be neglected. If the income tax cannot be extended for the purpose of reducing the national debt, another method must be devised. Whatever the outcome, the facts of the case must be set forth clearly before any single program for the reduction of debt is entitled to support.

Serious considerations of this nature lay behind the appointment of the Royal Commission in April, 1919. The commission's terms of reference were as follows:

To inquire into the Income Tax (including Super-tax) of the United Kingdom in all its aspects, including the scope, rates, and incidence of the tax; allowances and reliefs; administration, assessment, appeal and collection; and prevention of evasion; and to report what alterations of law and practice are necessary or desirable and what effect they would have on rates of tax if it were necessary to maintain the total yield.

In the course of its deliberations the commission held 50 sittings and examined 187 witnesses. The results of the hearings reached the public regularly and promptly in the form of the monthly "Instalments of Minutes of Evidence," the early numbers of which contained the mass of historical material noted above.

*The final report of the Royal Commission.* The report itself is a bulky volume containing, with the recommendations, a thoroughgoing summary of the income tax situation, as set forth in the evidence presented to the commission through the long period of its sitting. Although the report is signed by all the members, several have appended reservations concerning particular points.

The commission was convinced that its representative and diversified composition gave it a peculiar advantage in framing its recommendations.

In the introduction to the report the commission expressly disclaims the intention of making a fundamental change in the nature of the tax:

As it was in 1842 so in its essential features it should remain. The tax has proved its worth as a part of the fiscal system in all times of stress, especially in the last five years, and it is by its results that it must be judged. We recognize, and we think the public will recognize, that an old-established system that has entered into the thoughts and the business of the people of this country for several generations should be judged, not by a theoretical standard of possible excellence, but by the results which it has achieved. . . . We have made many recommendations for the alteration of the tax and, as we hope, for its improvement; but we have made no attempt whatever to overturn the whole framework of the tax and set up in its place something else bearing the same name.

The body of the report is divided into six parts, corresponding to the terms of reference. Part I deals with the scope of the tax, part II with rates and incidence, part III with allowances and reliefs, part IV with administration, part V with assessment, appeal, and collection, and part VI with the prevention of evasion.

*Exemptions and allowances.* The most striking recommendation made, and that which from the time of its publication has received the greatest amount of public attention and approbation, concerns the fixing of the exemption limit. The commission recommends that *this limit should be raised from £130 to £150 for single persons and £250 for married persons without children.*<sup>6</sup>

The recent history of the discussion centering around the exemption limit is briefly as follows: The exemption limit of £160, which was fixed in 1894, remained in force without change until 1915, when it was reduced to £130. The change to the lower figure was made in the face of a storm of opposition, which has never entirely subsided. It was urged that a tax at this level was essentially a tax on wages, affecting principally wage-earners who had incomes of more than £2 10s. a week. Moreover, the cost of collection of this part of the income tax must obviously be disproportionately large. The cost of collecting the tax from wage-earners was stated by the Board of Inland Revenue to be 7 per

<sup>6</sup> *Report*, part III, paragraph 246 (p. 56).

cent of the amount collected;<sup>7</sup> while Lloyd George is quoted as saying that the collection of the tax on the very low incomes of other than wage-earning people, "small shopkeepers and men who do odd jobs of all kinds," would cost the Exchequer as much as 70 per cent of the resulting collections.<sup>8</sup> The gain in receipts through the lowering of the exemption limit was placed at £1,000,000, an almost insignificant amount when the total yield of the tax is considered.<sup>9</sup>

The South Wales miners were especially active in opposing the retention of the exemption limit of £130. In June, 1919, Mr. Charles Edwards, M. P., appeared before the commission and in behalf of the South Wales Miners' Federation presented a protest against maintaining the limit at £130.<sup>10</sup> The protest was based principally on the arguments (1) that the reduction of basis had been made at a time when the cost of living was going up; (2) that the tax under these conditions pressed more heavily upon the poor than upon any other part of the community; and (3) that the cost of collecting this part of the tax was at least more than half the amount collected.<sup>11</sup> The exemption limit recommended by the miners' representatives was £250, a limit which had just previously been proposed by the Labor party and discussed in the House of Commons.<sup>12</sup> It was generally believed at this time that a refusal to work up to the point where wages would come inside the income tax limit was a common practice with the miners, a belief which was supported by the testimony of their representative in connection with the evidence noted above. In the autumn of 1919 the miners' opposition to the low exemption limit became so strong that a project for strike to resist the payment of income taxes on wages not exceeding £250 a year won a favorable majority in a strike ballot among the South Wales miners' organizations.<sup>13</sup> The strike was postponed, however, and no concerted action resulted.

Few witnesses before the commission failed to testify in some

<sup>7</sup> *Second Instalment of Minutes of Evidence*, appendix 8, p. 73.

<sup>8</sup> *Parliamentary Debates* (Commons), vol. 115 (1919), col. 1169.

<sup>9</sup> *Ibid.*, vol. 115 (1919), col. 1176.

<sup>10</sup> *Second Instalment of Minutes of Evidence*, pp. 114-125.

<sup>11</sup> The commission later noted the fact that the figures for cost of collection presented by the Board of Inland Revenue failed to support this contention as to cost.

<sup>12</sup> *Parliamentary Debates* (Commons), vol. 115 (1919), col. 1167.

<sup>13</sup> *The Times* (London), Dec. 2, 1919.

connection on the question of the exemption limit. Various higher figures were suggested, and a number of variations in the general scheme were proposed; but underlying the diverse testimony a general and strong sentiment in favor of raising the limit became apparent to the commission. The arguments presented are summarized in the report as follows:<sup>14</sup>

(a) The cost of living has greatly increased since the present limit was fixed.

(b) There should be no taxation on an income so small that it is only sufficient to satisfy ordinary human needs.

(c) Existing indirect taxation lays upon a person with a small income the full share of the State burden which he ought to be called upon to bear.

On the other hand, it was argued before the commission that the limit should be *lowered*, in order to make possible the lightening of the burden of indirect taxation, and also in order that the majority of the voters might not be absolved from direct payment towards the country's expenses.

The recommendation that the exemption limit should be raised to £150 for single persons and to £250 for married persons without children, is accompanied by the recommendation that *these limits should be maintained without fluctuation from year to year*, until there is a substantial change in the cost of living. In recommending the increases the commission states that it has given due consideration "to ability to pay and to the cost involved in collecting small sums of Income Tax . . . [and to the fact that] no tax can be successfully administered that is contrary to the general sense of justice in the community."<sup>15</sup>

Accompanying the recommendation for raising the exemption limit are suggestions that *the joint assessment of married persons should continue*; that *the wife allowance formerly permitted should disappear and be merged in the exemption allowed to a married couple*; that *the allowance for children should remain at £40 for the first child but should be increased from £25 to £30 for each subsequent child*; and that *the allowance for dependent relatives*, which formerly applied only to incomes of not more than £800, *should apply throughout the scale of income*.<sup>16</sup>

<sup>14</sup> *Report*, part III, paragraphs 240, 241 (p. 55).

<sup>15</sup> *Idem*, 246, 247 (p. 56).

<sup>16</sup> *Idem*, 260, 272, 282, 287 (pp. 54-63).



The general effect of these recommendations, as set forth graphically in the charts appended to the report, is to make the burden of the income tax *heavier* for single persons, especially for those with moderate incomes; *lighter* for married persons without children whose incomes are small; and *lighter* for married persons with children whose incomes are small or moderate.

Included in the same division of the report<sup>17</sup> are the recommendations that *allowance should be made for wasting assets in cases where the life of the asset falls short of 35 years*; that *no allowances should be granted to any other asset*; that *an increase should be made in the graduated allowances for houses of small annual value*; and that *allowances for life insurance premiums should be continued, but with a slight modification in rates*.

These changes in exemptions and allowances, if incorporated into law and income tax practice, are hardly calculated to cause noticeable changes in the amount yielded by the income tax. The advantage will lie in the satisfaction of the desire of the taxpaying community for a more equitable and convenient application of the tax.

*The differentiation plan.* The commission recommends that *the present differentiation against unearned incomes should be diminished*.<sup>18</sup> The device suggested, through which the differentiation may be lessened and the whole scheme simplified at one stroke, is the diminishing of earned income by one-tenth for the purposes of assessment. The income so diminished would be charged at the rate of tax applicable to unearned income. The commission comments incidentally on the public objection to the expression "unearned income," and advocates the substitution of the term "investment income"—a terminology the use of which is illustrated in the titles of the appended graphs.

The distinction between earned and unearned income for purposes of taxation is a recent development in British income tax practice. The Board of Inland Revenue makes the comment that "it is rather remarkable that an agitation that began as soon as Pitt introduced his Bill in 1798 and was carried on by a devoted succession of enthusiasts throughout the whole of the following century did not attain its legislative end until 1907."<sup>19</sup> The Select Committee of 1906, appointed to consider (in addition to

<sup>17</sup> *Report*, part III, paragraphs 187, 191, 232, 300 (pp. 41-72).

<sup>18</sup> *Report*, part II, paragraphs 109, 110 (p. 25).

<sup>19</sup> *First Instalment of Minutes of Evidence*, appendix 7 (b), p. 54.

graduation) the practicability of "differentiating . . . between Permanent and Precarious incomes," reported that differentiation on incomes not exceeding £3,000 a year was practicable, and could most conveniently be carried into effect by charging on such incomes a rate of tax lower than the normal or foundation rate. The difficulty of making a logical division between "earned" and "unearned" incomes was recognized, and the distinction between private traders' incomes and the profits of public companies was suggested as a possible working basis.

The committee's recommendation was approved and the general structure of the plan was incorporated in the Finance Act of 1907,<sup>20</sup> according to the terms of which the rate on earned income was placed at 9d. in the £ instead of 1s., provided that the taxpayer's income did not exceed £2,000. Subsequent finance acts have increased the degree of differentiation and have elaborated the scale of rates until there are at the present time five rates applicable to earned incomes up to £2,500, above which point the full normal rate is in effect.

In the course of the sessions of the Royal Commission in 1919, evidence was given that the scale of differential reliefs operated harshly against the smaller unearned incomes, especially as these are often derived from the investment of savings out of earned income. The commission reports that it is not practicable to attempt to decide how far income from investments is derived from the saved portion of earned income, but nevertheless presents a recommendation materially diminishing the differentiation against small incomes. The fraction one tenth, suggested for diminishing earned incomes for the purposes of taxation, would not only remove the present burden on unearned incomes at the foot of the scale—at the lowest point of which the differentiation is now in proportion to the fraction one fourth—but would also simplify the tax. Furthermore, the commission regards the point of £2,500, at which differentiation ceases, as wholly arbitrary, and recommends the substitution of £2,000, earned income. The maximum deduction for differential relief would consequently be £200.

*Graduation.* Immediately following the section on differentiation is a full discussion of graduation and recommendations for the simplification of the scheme.<sup>21</sup>

The movement for the graduation of the British income tax

<sup>20</sup> 7 Edward 7, c. 13, s. 19.

<sup>21</sup> *Report*, part II, sec. II (pp. 28-35).

has in many ways paralleled the movement for differentiation. Pitt's "Triple Assessment" and the following income tax of 1799 contained the feature of graduation for the smaller incomes, but not for the larger.<sup>22</sup> It was held at that time that graduation at the lower end of the scale was a practical necessity, but the suggestion of graduation at the upper end of the scale was regarded as an absurdity. From 1842 to 1853 the tax was charged at a uniform rate, but in 1853 a step was again taken in the direction of graduation by the introduction of an abatement for incomes of less than £150 at the time when Mr. Gladstone reduced the exemption limit to £100. This change was regarded by Mr. Gladstone, who remained a steadfast opponent of both differentiation and graduation, merely as a readjustment of the exemption limit. He refused to consider proposals for a graduated tax, on the ground that past experience showed that Pitt's system of graduation was bad, and that such a system "tended to communism." Another famous opponent of graduation, John Stuart Mill, described such a mode of taxation as "graduated robbery."

In succeeding years the fierceness of the opposition to the bare idea of graduation slowly died away. In 1894 Sir William Harcourt extended the abatement system for small incomes and announced his adherence to the principle of graduation for large incomes. In 1906 the Select Committee appointed to deal with the questions of graduation and differentiation noted in its report the fact that graduation up to £700 was already in force through the system of abatements, and stated that the system could be extended. In addition, the committee outlined the method of effecting graduation by means of a supertax, and gave it as its opinion that such a plan, although offering disadvantages and difficulties, was practicable.

These recommendations of the committee were not incorporated into law until the passage of the Lloyd George budget of 1909,<sup>23</sup> when a supertax was imposed on incomes of over £5,000. The Finance Act of 1914, passed before the outbreak of the war, further extended graduation. In 1918 the limit above which the supertax becomes payable was brought down to £2,500, and the maximum rate chargeable reached 4s. 6d., at which point it has remained.

The difficulties inherent in the methods of graduation now in

<sup>22</sup> *First Instalment of Minutes of Evidence*, appendix 7 (a), p. 51.

<sup>23</sup> 10 Edw. 7, c. 8, s. 66.

use are the presence of a series of diminishing abatements; the cessation of family allowances when the income is over £1,000; and the sudden increases in the tax payable by incomes slightly in excess of the points where the rates of tax are increased or where an abatement ceases. The commission set before itself simply the task of remedying these anomalies, for graduation itself is now "almost universally admitted to be as sound in principle as it is imperatively necessary in practice."<sup>24</sup>

A number of witnesses, among the most widely known of whom is Professor Edgeworth, suggested in their evidence before the commission the simplification of the scheme of graduation through the use of a mathematical function.<sup>25</sup> Such a method would have the advantage of smoothing the inequalities in the burden of the tax at the point where rates are changed, and would at the same time change the character of the taxation of the highest incomes from simply proportional to progressive taxation. On the other hand, as was stated by Dr. J. C. Stamp, perhaps the best known authority on British incomes, in his evidence before the commission, the first considerations are simplicity and convenience, rather than mathematical elegance.<sup>26</sup>

The one essential feature that emerges from the whole subject is that when all the mathematical elegancies have been satisfied, it is still impossible to say which of the various curves truly represents that principle of equality of sacrifice they purport to embody. . . . There is absolutely no common agreement among economists that a certain type of curve or formula is *economically* the most correct. If there were, then great sacrifices might be made to attain it in practice.

This being so, we are forced to consider simplicity and convenience first of all, associated with *any* degree of smoothness and adaptability. The wanton and bigoted way in which persons obsessed with certain mathematical ideas urge the sacrifice of all practical points to their lust for algebra, would be a serious public danger if their influence became great. If they are told that a certain smooth curve would entail abolition of taxation at the source, they reply quite unmoved that "taxation at the source must go." . . . I must say, with great conviction, that we should as a people make a very bad bargain if we sacrificed the principle of taxation at the source for the doubtful boon and inconclusive virtues of a curve even of most elegant functions and unimpeachable suavity.

The commission, of which Dr. Stamp became a member after

<sup>24</sup> *Report*, part II, paragraph 128 (p. 29).

<sup>25</sup> *Fourth Instalment of Minutes of Evidence*, p. 583.

<sup>26</sup> *Third Instalment of Minutes of Evidence*, pp. 463-464.

giving his evidence, quotes with approval his and other criticisms of the employment of formulae, and recommends instead a scheme for graduation which is briefly as follows:

*The taxable income (reached by deducting the appropriate allowances) should be charged at half the standard rate of tax where it does not exceed £225. If it exceeds £225, the first £225 should be charged at half the standard rate of tax, and the excess over £225 at the full rate of the tax.*<sup>27</sup> *The supertax should still be separately charged, and the point above which it is imposed should be £2000.*<sup>28</sup> The scale suggested by the commission reaches 5s. 6d. as its highest point.

*Taxation at the source.* The commission advocates the continuance of taxation by deduction at the source, which it regards as "of paramount importance, lying as it does at the very root of our Income Tax system."<sup>29</sup> In this decision the commission follows the example of the committees of 1905 and 1906 and fulfils the expectations of the public.

Taxation at the source has been employed in the collection of the British income tax since 1803, the date of the introduction of the five schedules,<sup>30</sup> and is commonly regarded as one of the chief reasons for the success of the tax. When the income tax was re-imposed in 1842, taxation at the source was again employed, and has been in use from that time to the present, with only slight modifications. The assessment of the supertax, beginning in 1910, marked a partial departure from the ordinary practice. The opponents of graduation had found one of their greatest supports in the general allegiance to this method of collection, but they were finally outgeneraled by the shaping of the graduation plans around the central one of taxation at the source. A second change, which marks a more serious departure from the method, was brought about by the direct assessment of certain of the war securities.

In recent years a movement for a simple and direct individual return of income from all sources has been steadily growing. It is stated that abatements, differentiations, allowances, exemptions, and the provisions for the supertax have so weakened the plan of taxation at the source that 99 per cent of all the incomes come

<sup>27</sup> *Report*, part II, paragraph 139 (p. 31).

<sup>28</sup> *Ibid.*, paragraph 152 (p. 35).

<sup>29</sup> *Report*, part II, paragraph 154 (p. 36).

<sup>30</sup> *First Instalment of Minutes of Evidence*, appendix 7 (g), p. 61.

under a separate survey, involving a separate assessment in each case.<sup>31</sup> Furthermore, many taxpayers who are not liable at the full rate are for the time being deprived of the use of the money which is eventually to be refunded to them—a loss which is a serious hardship to the taxpayers with the smaller incomes.

The commission recognizes the difficulties involved in adhering to the plan of taxation at the source, but is not satisfied that any other plan would yield as satisfactory results as the present system. In fact, the abandonment of the method at this juncture would, in the opinion of the commission, involve an enormous loss of revenue, and throw an unjust burden upon the conscientious and scrupulous taxpayer. The incidental inconveniences to particular classes of taxpayers should be minimized by special devices. In another section of the report,<sup>32</sup> however, the commission recommends that *so long as opinion amongst the wage-earners is strongly against the deduction of tax from wages by employers, the scheme should not be adopted*, and notes in this connection the fact that “there is no reason to believe that there is any considerable evasion of tax by this class of taxpayer.”

*Double taxation.* The questions of double taxation within the empire and of double taxation by the United Kingdom and the governments of foreign states were among the first taken under consideration by the commission. As the law now stands, persons resident in the United Kingdom and deriving income from the dominions, India, or from the colonies, as well as from foreign countries, are taxed on such income by the United Kingdom without regard to taxes levied by the governments under which the incomes arise, except for a series of concessions made during the latter part of the war.

Double taxation within the empire has existed for many years, but the situation was rendered particularly acute through the operation of the Finance Act of 1914, which extended the double taxation (formerly applicable only to income brought into the United Kingdom) to all income derived from abroad *whether or not it was brought into the United Kingdom*,<sup>33</sup> and by the increases in taxation throughout the empire during the war period. The imperial aspect of the question was recognized in 1916 and concessions which eventually reached a maximum of 2s. 6d. in the £

<sup>31</sup> J. A. Hobson, *Taxation in the New State*, p. 107.

<sup>32</sup> *Report*, part V, paragraph 498 (p. 109).

<sup>33</sup> 4 & 5 Geo. 5, c. 10, s. 5.

were made in the favor of double taxpayers within the empire. Further relief was postponed until after a post-war investigation.

It was represented to the Royal Commission that although the war represented a common effort by the empire without distinction, certain individuals within the empire who come to the mother country from the colonies for purposes of health, trade, education of children, and similar reasons, are in a sense singled out to pay twice over to the cost of the war. The commission recognized the inequities involved, and recommends the adoption of machinery for doing away with double taxation within the empire.<sup>34</sup> *In substitution for the existing partial reliefs there should be deducted from the appropriate rate of the United Kingdom income tax the whole of the rate of the dominion income tax on the same income*, subject to the limitation that in no case should the maximum rate of relief exceed one half of the rate of the United Kingdom income tax. If further relief is necessary in order to free the taxpayer from the entire rate of the lower of the two taxes, it should be given by the dominion concerned.

In the case of double taxation by the United Kingdom and foreign states the situation is more complicated, and its details gave rise to spirited interchanges of opinion in the hearings before the commission. It was represented to the commission that residents of Great Britain who derive a considerable amount of income from the United States are compelled to pay so large an amount of tax that only a small fraction of the original income remains; while in the United States the difficulties of the position of residents who derive income from foreign sources has been recognized in the setting off of tax against tax which is provided for in the revenue act of 1918; with the result of encouraging the citizens of the United States to undertake worldwide business, while British subjects resident in the United Kingdom are in effect penalized for so doing. A number of examples, similar in character to the following, were presented to the commission.<sup>35</sup>

A British subject resident in London constructs and owns an underground railway in New York. On the profits he would pay, first, American normal tax and surtax, and, second, on the residue, British income tax and super-tax. An American citizen resident in New York constructs and owns an underground railway in London. On the profits he would pay British income tax, but would only be charged

<sup>34</sup> *Report*, part I, paragraph 70 (p. 16).

<sup>35</sup> *Third Instalment of Minutes of Evidence*, p. 363.

American tax if the amount of this exceeded the amount payable in Great Britain.

Sir Archibald Williamson, M.P., who presented this illustration, stated that considerations of this nature induced the removal of business enterprises from Great Britain to foreign countries, so that they might escape double taxation. Even more important, in his opinion, were the losses to Great Britain through the non-establishment of companies with large capital stock.

In spite of the presentation of a mass of evidence of this kind, the commission reports that "*in the present circumstances we cannot recommend any change in the existing situation as to double taxation of the same income by the United Kingdom government and by the government of a foreign state.*"<sup>36</sup> In this conclusion the commission is supported by the Board of Inland Revenue.<sup>37</sup>

The decision of the commission is based principally upon the argument that the remission of taxes paid abroad would mark a serious departure from the principle of "ability to pay"; for the anomaly would arise of two British residents with equal incomes paying unequal taxes. The same privileges of residence would be enjoyed, and the only justification of differential treatment would be that one British resident had contributed to the revenue of a foreign state while the other had not, a consideration which the commission believes would not carry conviction to the ordinary taxpayer who would be called upon to make up the tax lost.

*The taxation of coöperative societies.* With the possible exception of the question of the exemption limit, no subject under consideration by the commission held the popular attention throughout the period of the sittings so steadily as the taxation of coöperative societies. The mass of evidence offered and the correspondence received were evidently a matter of surprise to the commission, and are described by them as more voluminous than the importance of the subject had led the members to expect.<sup>38</sup>

The great and rapid growth of the coöperative movement in recent years, the number of individual trading competitors who are adversely affected by its progress, and the large section of the community which is interested in the distribution of the societies' surpluses or profits, have caused public attention to be drawn to this question in a marked degree, and we have therefore considered the matter at a somewhat greater length than is warranted by its importance from an Income Tax point of view.

<sup>36</sup> *Report*, part I, paragraph 83 (p. 19).

<sup>37</sup> *Seventh Instalment of Minutes of Evidence*, appendix 60, p. 194.

<sup>38</sup> *Report*, part V, paragraph 537 (p. 118).



Coöperative societies registered under the Industrial and Provident Societies act of 1893 are exempt from all taxation under schedules C and D on trading profits, bank interest, and interest on investments. This exemption, which gives the coöperative societies an apparently favored position, was made a subject of inquiry by the Departmental Committee of 1905, which reported against a change in the law. In the interval between 1905 and the appointment of the present commission the coöperative movement has grown rapidly, and the resentment of private traders against the advantages given to the societies has gathered strength. The controversy which was laid before the present commission centered about the essential nature of the surplus of sales to members. The commission adopted the view that the surplus is simply a bookkeeping balance made for the purpose of determining what portion of the nominal purchase price shall be returned to the shareholder. When that discount or rebate shall have been returned to the shareholder, the surplus remaining in the hands of the society is a true trading profit. The commission therefore recommends that *any part of the net proceeds which is not actually returned to members is a profit which should be charged to the income tax.*<sup>39</sup> It is further recommended that a society should be treated exactly as a limited trading company under similar circumstances, and that wholesale and productive societies should be treated on exactly the same basis as distributive societies. The special treatment of agricultural coöperative societies under the income tax law should be discontinued.

*Administration.* A number of minor administrative changes are suggested in part IV of the report. The commission decided against making any direct investigation of the work of the Board of Inland Revenue, on the ground that they had received no evidence of the necessity of such an inquiry; on the contrary, they endorse the testimony of witnesses as to the efficiency of the work done by the board. The administrative changes recommended have to do with the centralization of the machinery of assessment and collection in the hands of the board. It is recommended that the office of assessor should be abolished; that the office of collector should be made a more important one, for which the appointments should be made through the Board of Inland Revenue; and that the areas of administration should be rearranged and be made independent of those of the old land tax.

<sup>39</sup> *Report*, part V, paragraph 550 (p. 120).

*Other recommendations.* The commission recommends that farmers, formerly taxed under Schedule B and given exceptional treatment largely on account of a proverbial failure to keep accounts, *should gradually be transferred to Schedule D and treated as the recipients of trading and other incomes are now treated.*<sup>40</sup> The average system as regards the profits of companies should be abolished, and *the preceding year's profits should be taken as the basis of assessment under Schedule D.*<sup>41</sup> *Casual profits*—that is, profits made on transactions recognizable as business transactions which lie outside the taxpayer's ordinary business but are entered into with a view to profitmaking—*should be brought within the scope of the income tax.*<sup>42</sup>

*The prevention of evasion.* The commission received important evidence on the evasion of the income tax, a part of which was excluded from the Minutes of Evidence on the ground that it might provide a guide to improper practices if placed in the hands of susceptible persons. The commission became convinced that at the present time there is a serious leakage through evasion. In each of the years 1917 and 1918 nearly £1,250,000 was paid into the treasury on account of the inquiries of revenue officials regarding income which had escaped assessment. The official witness of the Board of Inland Revenue estimated that from £5,000,000 to £10,000,000 additional might be brought into the treasury through the improvement of methods of administration in this respect. The commission accordingly recommends *heavier penalties for evasion and a greater stringency of administration.*<sup>43</sup>

*Reservations.* Although the report is signed by all the members of the commission, a number of "reservations" are appended. The majority of these have only one or two signatures; but a reservation stating that no part of the profits of coöperative societies should be subject to the income tax is signed by seven members; a reservation urging the abolition of differentiation is signed by five members (no one of whom was among the signers of the reservation previously noted), and a reservation stating that a fuller investigation of the income tax should have been undertaken, with a view to distributing the tax burden more widely,

<sup>40</sup> *Report*, part V, paragraphs 451, 452 (p. 100).

<sup>41</sup> *Idem*, part V, paragraph 479 (p. 105).

<sup>42</sup> *Idem*, part I, paragraph 91 (p. 20).

<sup>43</sup> *Idem*, part VI, paragraphs 632, 634, 635 (pp. 136-138).

is signed by four members, all of whom signed the reservation on differentiation.

*Summary.* The impartial tone of the report, the moderate nature of the recommendations, and the evidences of thoroughness which the publications of the commission present throughout, will undoubtedly classify the Royal Commission of 1919 as an able deliberative body. Whether the particular decisions of the commission will stand the test of time is a more doubtful question. Several of the recommendations bear more clearly the marks of the commission's desire to leave the general structure of the income tax undisturbed than evidence of the logical following-up of the material in hand. The refusal to consider the adoption of a mathematical formula to smooth tax rates and continue progression is based on the difficulty of ascertaining the type of curve which would conform to the instinctive judgment of the people, a difficulty which is equally serious in connection with the present system; upon the argument that it would not fit in with taxation at the source, a consideration which has several times been put aside as of lesser importance than the main proposal (notably in connection with the introduction of direct graduation); and upon the loss of duty and trouble and expense of collection, an argument unsupported by adequate evidence other than opinion. Similarly, the decision for the retention of taxation at the source rests upon the contention that its abandonment would involve a loss of revenue; while in connection with the discussion of the possible introduction of taxation at the source for wage-earners' incomes it is stated that the assessments are as adequate as on any other description of income and the payment of the tax by this class of taxpayers compares favorably with that of other classes.

Still another instance of the support of present procedure by the use of arguments not followed to a conclusion is contained in the statement that the abolition of double taxation by the United Kingdom and foreign governments would involve a serious departure from the principle of "ability to pay." The argument of the commission rests upon the implied statement that a resident of the United Kingdom who has paid a heavy tax abroad and a resident of the United Kingdom with equal income who has paid no taxes whatsoever abroad have an equal "ability to pay," and upon the express statement that the anomaly would appear of "two British residents with equal incomes paying very unequal

taxes" if the procedure were changed—a statement which is incorrect unless the words "to the United Kingdom" are added.

More serious still is the failure of the commission to express recognition of the seriousness of the financial situation of the country. If it was found undesirable to *raise* the rates of the tax in such manner that an appreciably larger revenue would be gained, the conclusion and the evidence upon which it was based should have been presented. If it was found undesirable to *lower* the tax the conclusion and the evidence supporting it should have been presented. The four members of the commission who signed the reservation on the scope of the inquiry had in mind considerations of this nature in making the statement that "an inquiry into the scope and incidence of a tax is incomplete unless the effect of that tax is considered in connection with other burdens; and unless taxation is regarded not merely from the point of view of the individual, but from that of its general result on production, industry, and saving." Already the results of these sins of omission are being felt. The budget proposals of April 19, 1920, contain a restoration to a high level of the excess profits tax, which had been reduced in 1919. The obvious conclusion is this: failing an extension of the income tax or the suggestion of an alternative measure, a high excess profits tax is to become a permanent part of the British taxation system.

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